DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL

FROM: ASSISTANT CHIEF COUNSEL (Field Service)
CC:DOM:FS

SUBJECT: Income Forecast Depreciation--Mortgage Servicing Rights

This Field Service Advice responds to your memorandum dated
Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer	=
Parent	=
Subsidiary	=
Year 1	=
Year 2	=
Year 3	=

ISSUES:

1. Whether the income forecast method of depreciation may be used to amortize purchased mortgage servicing rights.

2. Assuming that the income forecast method may be so used, whether income forecast amortization reported on original returns using mid-year data may be recomputed on amended returns using end-year data.

CONCLUSIONS:

1. The income forecast method has been allowed as an acceptable method of computing depreciation only for specified types of assets for which time-based methods of depreciation are not suitable. Pools of mortgage servicing rights are not among the specified types of assets, and have been treated by case law as appropriate for straight line, time-based depreciation. Further, pools of mortgage servicing rights do not qualify for the income forecast method because they are not characterized by an erratic income stream dependent upon popularity, but rather by a steadily declining stream of income.

2. The filings of amended returns changing from use of mid-year data to end-year data in the calculation of Taxpayer's depreciation deduction on its amended returns for years 1, 2 and 3 are unauthorized changes in method of accounting and cannot be done without the permission of the Commissioner. In addition, the amended returns did not treat the amortization of the pools of mortgage servicing rights in an allowable manner and, therefore, are unacceptable and invalid.

FACTS:

Taxpayer is a wholly-owned subsidiary of Parent. Subsidiary is a wholly-owned subsidiary of Taxpayer. Taxpayer and Subsidiary filed consolidated income tax returns with Parent for years 1, 2, and 3.

Taxpayer originates, purchases, sells, and services residential mortgage loans. At issue is servicing purchased from other servicers. Servicing involves collecting the homeowners' monthly payments, remitting principal and interest to the investors, handling an escrow fund for payment of insurance and taxes, and handling delinquencies. Taxpayer receives a portion of the homeowners' interest payments for performing its services.

Taxpayer acquired the servicing at issue through asset purchases rather than stock acquisitions, making Taxpayer's basis in this purchased servicing the purchase price, less accumulated depreciation. Subsidiary also had purchased servicing.

A decline in interest rates during years 1, 2, and 3 caused a substantial increase in loan payoffs due to an increase in refinancing as well as increased home sales. The dollar value of Taxpayer's servicing portfolio consequently decreased.

Purchased mortgage servicing rights are an amortizable intangible asset. Taxpayer acquired purchased mortgage servicing rights in each of the years 1, 2, and 3, as it did in a number of years prior to year 1. Taxpayer utilized the income forecast method for amortizing its purchased mortgage servicing rights. The amortization was computed by multiplying the unamortized basis of the purchased servicing asset by a percentage based on the portion of income expected to be received in the current period, divided by the total amount of income expected to be received over the balance of the servicing period. The expected income for the current period and the total expected income were reestimated each year.

During years 1, 2, and 3, Taxpayer's book treatment of purchased servicing was governed by Statement of Financial Accounting Standards No. 65, Accounting for Certain Mortgage Banking Activities. In part, Statement No. 65 provides that "(t)he amount capitalized as the right to service mortgage loans... shall be amortized in proportion to, and over the period of, estimated net servicing income (servicing revenue in excess of servicing costs)."

Each year Taxpayer used a computer model to estimate income expected to be received in the current period and future expected income. The calculation considered factors such as principal balance, remaining life, servicing fee rate, servicing costs, tax costs, usage of principal and interest float, usage of escrow, foreclosure losses, income from fees and insurance, and prepayment speeds. Principal balance and prepayment speed were the most important factors.

For year 1, Taxpayer calculated new amortization rates each month. There were different rates for the servicing assets grouped by year of acquisition. For year 2, Taxpayer changed the asset composition, grouping all pre-year 2 purchased servicing into one asset for purposes of calculating its monthly amortization and using a certain amortization rate for the first three months of year 2 and another certain amortization rate for the last nine months of year 2. For the year 2 purchased servicing, yet other rates were used for the first three months and the last nine months of year 2. For year 3, a particular amortization rate was used for all pre-year 3 purchased servicing except for the largest purchase, which received a different rate. Yet another rate was used for the year 3 purchased servicing.

On their consolidated income tax returns for years 1, 2, and 3, Taxpayer and Subsidiary claimed certain amounts as "other deductions" for amortization of their purchased servicing assets. The total amortization taken on the original income tax returns was identical to book amortization, except that the enactment of I.R.C. § 167(f)(3) required straight-line, 108 month amortization of those purchased after August 10, 1993. An M-1 adjustment was accordingly made.

Subsequently, Parent filed amended income tax returns requesting additional deductions with respect to amortization of the purchased mortgage servicing rights for years 1, 2, and 3. The amended returns used the same computer model as had been used on the original returns, though the data input into the model changed.

The loans were grouped differently for purposes of computing amortization on the amended returns from the groupings used in calculating amortization on the original returns. For the amended returns, loan amortization rates were calculated on a group basis for each of the year 1, 2, and 3 acquisitions, the acquisitions for the first pre-year 1 year, and the acquisitions for the remaining pre-year 1 years treated as a group. For year 1, Taxpayer determined which group a loan belonged to based on the loan's year of origination. For years 2 and 3, Taxpayer determined which group a loan belonged to based on the year when Taxpayer acquired the loan.

Moreover, the amortization rates used for the amended returns varied from the book amortization indicated by the original returns. Except for the amortization for the first pre-year 1 year grouping claimed for the year 1, the amortization claimed with respect to each grouping of mortgage servicing rights was larger on the amended returns than on the original. In the instance of the amortization rate for the first pre-year 1 grouping claimed for year 3, the revised amortization rate was twice as high on the original returns as on the original. The increased amortization reflected the use of year-end data for the computer modeling rather than the mid-year data reflected in the original returns. The mid-year data input one half of year end principal and escrow into the formula, and assumed a zero percent payoff for the first year. However, end-year data reflected lower principal than had been originally expected. Moreover, use of year end data input higher prepayment speeds, reflecting the unexpected high prepayments which occurred, into the model.

The income forecast method of depreciation calculates depreciation by applying a fraction whose numerator is the actual income earned during the taxable year and whose denominator is the estimated total income to be earned during the asset's useful life. An estimate made at the end of the year is presumably more accurate than estimates at the beginning of or during the year, since more information is available. However, Taxpayer's original returns used mid-year data and used estimated figures for both income to be earned during the year and total income to be derived from the asset, as did the amended returns.

LAW AND ANALYSIS

Section 167(a) provides for a depreciation deduction and allows a reasonable allowance for the exhaustion, wear and tear, including a reasonable allowance for obsolescence, of property used in the trade or business or held for the production of income.

For tangible property, section 168(a) provides that except as otherwise provided in section 168, the depreciation deduction provided by section 167(a) shall be determined by using the applicable depreciation method, recovery period, and convention. The Modified Accelerated Cost Recovery System (MACRS) which section 168(a) prescribes for tangible property was enacted by the Tax Reform Act of 1986 for property placed in service after 1996 (Sec. 201 of Pub. L. No.99-514, Oct. 22, 1986).

For intangible property, Treas. Reg. § 1.167(a)-3 provides that an intangible asset known from experience or other factors to be of use in the business or in the production of income for only a limited period whose length can be estimated with reasonable accuracy may be the subject of a depreciation allowance.

Treas. Reg. § 1.167(a)-1(a) provides the general rule that the allowance provided by section 167(a) is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside plus salvage value will equal the cost or other basis of the property at the end of its useful life. The allowance shall not reflect amounts representing a mere reduction in market value.

Treas. Reg. § 1.167(a)-1(b) provides that the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may be expected to be useful in the trade or business or in the production of income. The period is determined by reference to the taxpayer’s experience with similar property taking into account present conditions and probable future developments. If the taxpayer’s experience is inadequate, the general experience of the industry may be used until the taxpayer’s experience forms an adequate basis for the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary but only when the change in useful life is significant and there is a clear and convincing basis for the redetermination.

Treas. Reg. § 1.167(b)-1 provides that the straight line method may be used in determining a reasonable allowance for depreciation for any property which is subject to depreciation under section 167 and shall be used in all cases where the taxpayer has not adopted a different acceptable method.

Taxpayer in this case has not applied the straight line method of amortization to its purchased pools of mortgage servicing contract rights, but has determined amortization by using an income forecast method. Taxpayer’s amortization has been computed by multiplying the unamortized basis of the purchased servicing asset by a percentage based on the portion of income expected to be received in the current period, divided by the total amount of income expected to be received over the balance of the servicing period.

Rev. Rul. 60-358, 1960-2 C.B. 68, administratively allowed the “income forecast” method as an acceptable method for computing a reasonable allowance for depreciation under section 167(a) with respect to a specified type of property, leased or rented television films. This method requires the application of a fraction whose numerator is the actual income for the films for the taxable year and whose denominator is the forecasted or estimated total income to be derived from the films during their useful life. If in subsequent years it is found that the income forecast was substantially over- or underestimated, an adjustment of the remaining income forecast for the subsequent years may be made. The total forecast income should be based on the conditions known to exist at the end of the period for which the return is made. The estimate can be revised upward or downward at the end of subsequent taxable periods.

Rev. Rul. 60-358 reasoned that the income from television films has a strikingly uneven, erratic flow resulting from audience appeal. Additional income will be received from the reruns of successful film series, depending upon popularity. The usefulness of such assets is measurable over the income it produces and cannot be adequately measured by the passage of time alone. To avoid distortion, depreciation must follow the flow of income. Rev. Rul. 60-358 states that the principle of “income forecast” is limited in its application to television films, taped shows for reproduction, and other property of a similar character. Rev. Rul. 64-273, 1964-2 C.B. 62, held that motion picture film is included in property of a similar character.

Rev. Rul. 78-28, 1978-1 C.B. 61, holds that since the reason for using the income forecast method to depreciate movie films is to minimize the distortion of income by matching depreciation deductions with income derived from assets giving rise to the deductions, income reflected in the numerator of the fraction used to compute the depreciation deduction for the tax year must reflect the same gross income used to compute taxable income from the film for the same period. Rev. Rul. 78-28 also described sound recordings and books as other similar property described under the income forecast method.

Rev. Rul. 79-285, 1979-2 C.B. 91, holds that the income forecast method of depreciation may be used to compute depreciation deductions for book manuscripts, patents, and master recordings. Rev. Rul. 89-62, 1989-1 C.B. 78, examined the treatment of video cassette rental recordings. It noted that section 168(f)(3) provides that section 168 does not apply to any motion picture film or video tape, and held that videotapes are among the video tapes excluded from the scope of section 168, but may be depreciated under the straight line or income forecast method.

Rev. Rul. 89-62 further stated that the income forecast method recognizes that certain assets generate uneven flows of income and have unique income producing potential. To properly apply the income forecast method, there must be income projections for each asset subject to the method. Groupings by videocassette title are permissible for making income projections, but broader groupings are not.

Rev. Rul. 95-52, 1995-2 C.B. 27, holds that consumer durable property subject to rent-to-own contracts is not property depreciable under the income forecast method. Rev. Rul. 95-52 notes the television and movie films, taped shows for reproduction, book manuscripts, patents, master recordings, and other property of a similar character allowed by Rev. Ruls. 60-358, supra, 64-273, supra, and 79-285, supra. It describes these assets as assets of an artistic or creative character generating uneven flows of income and having unique income-producing potential. Rev. Rul. 95-52 states that the passage of time generally is not an appropriate measure of the useful life of this property, whereas the useful life of consumer durable property is appropriately measured by the passage of time and not by the income produced.

1. USE OF INCOME FORECAST METHOD FOR PURCHASED MORTGAGE SERVICING RIGHTS

Pools of mortgage serving rights are intangible assets. Treas. Reg. § 1.167(a)-3 provides that an intangible asset known from experience or other factors to be of use in the business for only a limited period whose length can be estimated with reasonable accuracy may be the subject of a depreciation allowance. The right to service a pool or portfolio of mortgage servicing rights has been held to constitute an intangible asset within the meaning of Treas. Reg. § 1.167(a)-3 which has an average life span whose length can be estimated with reasonable accuracy. Western Mortgage Corporation v. United States, 308 F. Supp 333 (C.D. Cal.1969); Securities-Intermountain, Inc. v. United States, 460 F.2d 261 (9th Cir. 1972); First Pennsylvania Banking & Trust Co. v. Commissioner, 56 T.C. 677 (1971), acq., 1972-1 C.B. 2; Securities-Intermountain, Inc. v. United States, 460 F.2d 261 (9th Cir. 1972); First National Bank of Omaha v. Commissioner, T.C. Memo. 1975-67.

Moreover, for property acquired after August 10, 1993 (Sec. 13261(g) of Pub. L. No. 103-66, Aug. 10, 1993), the Internal Revenue Code explicitly recognizes that mortgage servicing rights are intangible assets in sections 167(f)(3) and 197(e)(7). Section 167(f)(3) provides that if a depreciation deduction is allowable under section 167(a) with respect to a mortgage servicing right described in section 197(e)(7), the deduction is computed using the straight-line method and a 108-month useful life. Section 197(e)(7) excepts mortgage servicing rights secured by residential real estate from the usual 15-year amortization provided by section 197(a) for intangibles, unless such right is acquired in a transaction involving the acquisition of assets constituting a trade or business.

Prior to being stricken generally for property placed in service after November 5, 1990 (Sec. 11812(a)(1) and (c)(1) of Pub. L. No. 101-508 (Nov. 5, 1990)), section 167(b) determined that certain methods of accelerated depreciation including the declining balance and sum of the years-digits methods were reasonable allowances for purposes of section 167(a). Section 167(c) provided that this determination applied only for property other than intangible property with a useful life of three years or more. However, there was no such determination in the Internal Revenue Code of methods of depreciation considered reasonable for intangible property. Of course, the straight line method is always deemed to be a “reasonable allowance” for depreciation. Treas. Reg. § 1.167(b)-1 states that the straight line method may be used in determining a reasonable allowance for any property which is subject to depreciation under section 167 and shall be used in all cases where the taxpayer has not adopted a different acceptable method. For other methods of depreciation with respect to intangible assets, any method which the taxpayer uses must be shown to be reasonable pursuant to section 167(a).

The income forecast method is not an acceptable method of depreciation for pools of mortgage servicing rights, but is an acceptable method depreciation only for specified types of property which have an erratic stream of income and a usefulness dependent upon consumer appeal. The income forecast method of depreciation was created by Rev. Rul. 60-358 and specifically limited to television films, including taped shows for reproduction, and other property of a similar character.

In discussing television films, Rev. Rul. 60-358 states that they have a distortion of income caused by a strikingly uneven, erratic flow of income resulting from audience appeal. A successful film series will receive additional income from reruns over a period of years, depending upon popularity, while unsuccessful series may produce little or no income after the initial exhibition. The usefulness of such assets is measurable over the income they produce and cannot be measured by the passage of time alone. Rev. Rul. 60-358 therefore states that it is the position of the Service that the income forecast method constitutes an acceptable method for computing a reasonable allowance for depreciation of television films under section 167(a).

Other rulings make plain that the income forecast method is not a method of general application but is suitable only for specified other property with a character similar to that of the television films considered in Rev. Rul. 60-358. Rev. Rul. 64-273, supra, ruled that motion pictures are other property of a similar character to the television films. Rev. Rul. 78-28, supra, states that sound recordings and books are similar property. Rev. Rul. 79-285, supra, additionally mentions patents. Rev. Rul. 89-62, supra, states that videocassettes are among the “motion picture film or video tape[s]” which section 168(f)(3) excludes from the application of section 168, i.e., from MACRS. Section 168(f)(3), still current, was added by Sec. 201(a) of Pub. L. No. 99-514

Moreover, the legislative history of former section 167(c) indicates a Congressional awareness that the income forecast method was only available for certain types of property. Section 167(c) was amended to provide that paragraphs (2), (3), and (4) of section 167(b) do not apply to any motion picture film, video tape, or sound recording (Sec. 1809(d)(1) of Pub. L. No.99-514 (Oct. 22, 1986)), effective generally for property placed in service after March 28, 1985 (Sec. 1881 of Pub. L. No 99-514). H. Rep. No. 99-426, 99th Cong., 1st Sess. 915 (1985), 1986-3 (Vol. 2) C.B. 915, states that films, videotapes, and sound recordings were not eligible for the accelerated depreciation methods of former section 167(b)(2), (3), or (4), but the income forecast method or similar methods were available. There is no mention of the income forecast method as being suitable for any type of property other than those specified.

The rulings also make plain that those types of property which may receive the benefit of the income forecast method are those having uneven flows of income and uniquely influenced by popularity. Rev. Rul. 89-62 refers to the unique income producing potential of the eligible assets and moreover states that groupings of videotapes broader than by title are impermissible under the income forecast method. Rev. Rul. 95-52 refers to the eligible assets as artistic or creative with uneven flows of income and unique income producing potential.

Those assets for which the income forecast method is permissible are characterized by an erratic flow of income. Rev. Rul. 60-358 refers to the “strikingly uneven flow of income.” Rev. Rul. 60-358 further states that the usefulness of such assets in the taxpayer’s trade or business is measurable over the income produced and cannot be measured by the passage of time alone. Rev. Rul. 78-28 makes plain that the income forecast method is only available for specified assets for which the measurement of depreciation by time would fail to produce a reasonable matching of depreciation and income. Rev. Rul. 78-28 states that the reason for the income forecast method is to minimize the distortion of income by “matching depreciation deductions with income derived from assets giving rise to the deductions.”

Individual mortgage servicing rights (MSR’s) have a contractual life in terms of years and the life is co-terminus with the underlying mortgage obligation. The industry readily estimates average useful lives of pools of MSR’s using accepted statistical analysis, reflecting the impact of refinancing, home sales, and other factors. While the income derived from the pool of MSR’s declines over time as the outstanding balance of the underlying mortgages declines (due to principal pay down, refinancing, sale of homes and other reasons), such income is measured over time. The anticipated, declining income stream over time can be projected and is the basis for determining the purchase price of a pool of MSR's. The availability of such projection makes the asset depreciation determinable (though not necessarily level) over time under section 167(a). This income stream is not erratic, nor a function of the popularity of the underlying mortgages.

Taxpayer's pools of mortgage servicing rights are not influenced by considerations of popularity and are not characterized by uneven income flows. The decision to refinance a mortgage or to pay off a mortgage and move to another home as a result of a decline in interest rates is a purely economic decision unrelated to any passing subjective consumer or esthetic appeal of the mortgage.

Moreover, television films and similar assets can have truly erratic income streams which may increase or decline each year for a completely unpredictable number of years. The income stream from a pool of mortgage servicing rights is not erratic and can be projected to average a certain useful life at the time of the pool's acquisition. This income stream never increases, but only declines over time. This steady decline is contrary to the concern which Rev. Ruls. 89-62 and 95-52 expressed with the income producing "potential" of an eligible asset, i.e., with the possibility of significant upswings.

The most that can be said is that the refinancing of individual mortgages amounts to their retirement. Treas. Reg. § 1.167(a)-8 governs losses on the retirement or permanent withdrawal of depreciable property from the trade or business. The tax consequences of a retirement depend upon whether the asset is accounted for in a separate or mass asset account. Taxpayer's mortgage servicing rights are pooled assets. Treas. Reg. § 1.167(a)-8(d)(1) and (2) provides that an early loss is not allowable on the retirement of an asset in a multiple asset account.

Taxpayer's pools of mortgage servicing rights are unlike the specific assets for which the income forecast method was held permissible in the above cited rulings. For the assets named in the rulings, depreciation over time creates a distortion from non-time related, uneven income generated by the assets. This is the reason why the rulings administratively recognize that the income forecast method is an acceptable method for computing a reasonable depreciation allowance under section 167(a) only for specific assets under specific conditions of erratic income. See, Schneider v. Commissioner, 65 T.C. 18, 32 (1975), and Wildman v. Commissioner, 78 T.C. 943, 950 (1982), stating that the Commissioner has authorized the use of the income forecast method under section 167(a) for amortizing films because of the uneven flow of income earned by this type of property.

The income forecast method, however, is not a reasonable method for computing a reasonable depreciation allowance for all types of asset under any condition. There is no statutory or regulatory authority that treats any assets other than those specified administratively or by legislation as eligible for the income forecast method pursuant to section 167(a). It may be inferred that Congress agrees with this interpretation. Section 1086(a) of Pub. L. No. 105-34 (Aug. 5, 1997) added section 197(g)(6) to the Internal Revenue Code, effective for property placed in service after August 5, 1997 (Sec. 1086(c) of Pub. L. No. 105-34). Section 197(g)(6) limits use of the income forecast method to films, video tapes, sound recordings, copyrights, books, patents, and other property specified in regulations. While this legislation is prospective, the legislative history describes this provision as clarifying, i.e., not as changing, the types of property to which the income forecast method may be applied. H.R. Rep. No. 105-148, 105th Cong., 1st Sess. 513, 514 (1997); H.R. Rep. No. 105-220, 105th Cong., 1st Sess. 601 (1997).

That there is no regulatory authority for treating assets other than those specified in the rulings and legislation as eligible for the income forecast method may be inferred from Treas. Reg. § 1.167(a)-1. This provision allows for a change in the scheduled depreciation allowance for a modification of an asset's estimated useful life by reason of conditions known to exist at the end of the taxable year, though only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. However, there is no general regulatory authority for allowing changes in depreciation in later years of the asset's useful life to reflect changes in projected income, as is done under the income forecast method. The regulation denies a depreciation allowance for changes in value.

Carland, Inc. v. Commissioner, 90 T.C. 505 (1988), aff'd 909 F.2d 1101 (8th Cir. 1990), concerned the depreciation for the years 1970 through 1975 of tangible property, including railroad rolling stock, automotive equipment, aircraft, and data processing equipment, which the taxpayer leased out under short-term leases. This property was found eligible for the double-declining balance method under section 167(b), but ineligible for the income forecast method. The Tax Court stated that Rev. Rul. 60-358 was tailored to meet the inadequacies of time-based methods of depreciation, which when applied to the unique property film, resulted in distortions of income. With respect to the tangible assets under consideration, the Tax Court stated that the usefulness of such assets is adequately measured by the passage of time, whereas the income forecast method keys the useful life of the asset to the income provided.

However, the recent case of ABC Rentals of San Antonio, Inc. v. Commissioner, T.C. Memo. 1994-601, rev'd 97 F.3d 392 (10th Cir. 1996), reh'g 142 F.3d 1200 (7th Cir. 1998), considered the depreciation for the years 1987 and 1988 of consumers durables which the taxpayers leased out on short-term leases. The Tenth Circuit held that the taxpayer could elect to exclude its tangible property from MACRS pursuant to section 168(f), a proposition which is not here relevant because Taxpayer's pools of mortgage servicing rights are intangible assets which do not fall withing the MACRS scheme but are instead depreciated pursuant to section 167(a).

The Tenth Circuit stated that the taxpayer bears the burden of proving that the method of depreciation produces a reasonable allowance for depreciation. The Tenth Circuit cited Treas. Reg. § 1.67(a)-1(a) for the proposition that a reasonable allowance is that amount which should be set aside for the tax year "in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property... "

The Tenth Circuit also cited Treas. Reg. § 1.167(b)-0(a), which provides that any reasonable and consistent method of computing depreciation may be used under section 167, but also states that depreciation deductions shall not exceed "such amounts as may be necessary to recover the unrecovered cost or other basis less salvage value during the remaining useful life of the property." The Tenth Circuit noted that the Commissioner had conceded that the income forecast method was the most economically accurate method of depreciating the property, thus conceding the reasonableness of the method.

The Tenth Circuit's reliance on Treas. Regs. § 1.167(a)-1(a) and 1.167(b)-0(a) was inappropriate. These regulations allow the use of a reasonable time based method over an asset's useful life, but the income forecast method is not keyed to an asset's useful life. It is a reasonable method of depreciation under section 167(a) only for assets specified in rulings and later in legislation that are recognized to have an erratic income stream dependent upon popularity. The simple fall off of income which occurs to pools of mortgage servicing rights is not an erratic stream of income and is not a result of subjective consumer popularity

The Tenth Circuit's second opinion in ABC Rentals, supra, acknowledged that the above mentioned legislative history of section 197(g)(6), which limits use of the income forecast method to specified types of property for property placed in service after August 5, 1997, characterized this change as a clarification. However, it stated that the views of one Congress on the meaning of legislation passed by an earlier Congress are ordinarily not entitled to great weight. United States v. X-Citement Video, 513 U.S. 64 (1994). The Tenth Circuit failed to consider the effect on the above-mentioned legislative history of the last sentence of section 167(c), effective for property placed in service after March 28, 1985. Congress stated that under the bill, "films, video tapes, and sound recordings" are not eligible for the accelerated depreciation methods under section 167(b)(2), (3), or (4), but the income forecast method was available. H. Rep. No. 99-426, supra, at 915. Thus, it is evident that an earlier Congress envisioned the income forecast method only in terms of certain specified types of property. While the legislative history does not explicitly so state, films, videotapes, and sound recordings are all characterized by erratic income flows depended upon popularity, the very factors which led to the adoption of the income forecast method in Rev. Rul. 60-358, supra.

Lastly, even if the income forecast method were available, Taxpayer has not applied it properly. Rev. Rul. 60-358 requires the application of a fraction whose numerator is the (actual) income from the asset for the taxable year and whose denominator is the estimated total income to be derived from the asset. Rev. Rul. 60-358 further states that the estimated income to be derived from the asset should be based on conditions known to exist at the end of the period for which the return is made. Rev. Rul. 78-28, supra, requires that the income reflected in the numerator of the fraction used to compute the depreciation deduction for the tax year must reflect the same gross income used to compute taxable income from the asset for the same period.

On both its original and amended income tax returns, Taxpayer used estimated rather than actual figures for current year income. Morever, the use of mid-year data on the original return is inconsistent with the requirement that estimated income be based on information known to exist at the end of the taxable period. In addition, Taxpayer applied the calculated depreciation rate to a redefined asset in subsequent years.

In light of all the above, Taxpayer's pools of mortgage servicing rights are not among the types of assets specified by revenue rulings or legislation as those for which the income method provides a reasonable allowance for depreciation under section 167(a). Additionally, pools of mortgage servicing rights do not qualify for the income forecast method because they are not subject to strikingly uneven income streams, dependent upon consumer popularity.

2. AMENDED RETURN USING END-YEAR DATA

Taxpayer's original returns computed amortization of its pools of mortgage servicing rights under the income forecast method using mid-year data. The data input one half of year-end principal and escrow into Taxpayer's formula. Taxpayer filed amended returns which computed amortization using end-year data while reflecting lower principal and higher prepayment speeds than had originally been expected. It does not appear the amended returns correct errors on the original returns, and it has not been established that the original returns contain miscalculations. While Taxpayer's amended returns used end-year rather than mid-year data, the amended returns were based on facts that existed at the time that the original returns were filed.

The question arises whether Taxpayer's original returns should be considered to have made a binding election to use mid-year data, precluding use of the end-year data. "Oversight, poor judgment, ignorance of the law, misunderstanding of the law, unawareness of the tax consequences of making an election, miscalculation, and unexpected subsequent events have all been held insufficient to mitigate the binding effect of elections made under a variety of provisions of the Code." Estate of Stamos v. Commissioner, 55 T.C. 468, 474 (1970). While estimates whose accuracy depends upon the judgment of the person who established them may not be retroactively corrected under the doctrine of election, mathematical errors in computation may be corrected. Pacific Mutual Life Insurance Co. v. Commissioner, 48 T.C. 118 (1967), rev'd on another issue, 413 F. 2d 55 (9th Cir. 1969). It would appear that Taxpayer's decision to use end-year data on the amended returns was a judgment as to the type of variables to be used in its formula rather than correction of a mathematical mistake.

However, such cases dealing with the doctrine of election generally concern a situation where the Taxpayer is required by statue or regulation to make an affirmative action of election between two allowable methods of treating an item. Moreover, the Form 4562, Depreciation and Amortization, does not indicate any election to be made with regard to intangible assets or the income forecast method. There is no such indication on lines 39 and 40, dealing with amortization of costs beginning respectively in the current and prior years, or on the line 40 total amortization to be carried to the "other deductions" line of the Form 1120, U.S. Corporate Income Tax Return, where Taxpayer reported the income.

Even if the Taxpayer were deemed to have made an election on its original returns with respect to the income forecast method, its use of mid-year data conflicted with the requirement of Rev. Rul. 60-358, supra, that the estimated income to be derived from the asset should be based on conditions known to exist at the end of the period for which the return is made. In Mamula v. Commissioner, 346 F.2d 1016 (1965), rev'g 41 T.C. 572 (1964), the taxpayer made an election of the deferred payment method of reporting the gain from a sale. However, the deferred payment was unavailable where the notes had an ascertainable fair market value. The Commissioner sought to treat the entire profit as currently taxable rather alternatively to allow use of the installment method.

The Tax Court denied use of the installment method, noting noncompliance with the regulation's requirement that election of the installment method be made in the year of sale. The Ninth Circuit stated that the taxpayer could not be bound by his original election because it was a nonallowable choice. No one was bound. Although the consideration that the taxpayer therein was not using hindsight to seek a more advantageous method also influenced the Ninth Circuit, the point remains that it does seem inequitable to seek to hold a taxpayer to a nonallowable choice.

Similarly, in Foley v. Commissioner, 56 T.C. 765 (1971), the taxpayer used the double declining balance method of depreciation on his original return, not knowing that statute made it inapplicable for used property. By amended return, he chose the 150-percent declining balance method. The court stated that the Commissioner could not avail himself of the Taxpayer's mistake to force upon him the least favorable method of depreciation, straight line in this instance. In the present case, Taxpayer’s amended returns (which did, however, continue to have the infirmity of using estimated actual income for the current taxable year, contrary to Rev. Rul. 60-358) were at least less incorrect than the original returns.

Even if the assumption is made that pools of mortgage servicing rights are among the types of property for which the income forecast method is allowable, and the further assumption is made that Taxpayer’s amended returns had properly applied the income forecast method, the amended returns were unauthorized changes in a method of accounting. Taxpayer used mid-year data in its calculation of the income forecast method in its original returns for years 1, 2 and 3. Where a taxpayer seeks to change the treatment in a material item used in an overall plan of accounting, such a change is a change in a method of accounting. Treas. Reg. §1.446-1(e)(2)(ii)(a). Where a taxpayer has applied an erroneous method of accounting for two consecutive returns, the taxpayer has adopted a method of accounting. Rev. Rul. 90-38, 1990-1 C.B. 57**.** A taxpayer cannot make a change in a method of accounting without permission of the Commissioner. Section 446(e). Whether the taxpayer will be allowed to change its method of accounting is within the discretion of the Service in this instance. The Service will not follow Gimble Bros., Inc. v. United States, 535 F.2d 14 (Ct. Cl. 1976), in which the court permitted the taxpayer to file amended returns for prior years to effect a change in method of accounting for a material item. Rev. Rul. 90-38, supra. With respect to the yearly changes in the composition of the asset to which Taxpayer applied the income forecast method, because Taxpayer has not used a consistent erroneous method for two consecutive returns, Taxpayer has not established a method of accounting. Rev. Rul. 90-38, supra. Based on Foley, supra, and Silverqueen, 55 T.C. 1101 (1971) the taxpayer is entitled to adopt a proper method of accounting by a amended return.

However, the filing of amended returns is not a statutory right and their acceptance or rejection is a matter of administration within the discretion of the Commissioner. Shall & Co. v. United States, 129 F. Supp. 137 (S.D.N.Y. 1954). The Service considers an amended return filed by the due date of the original return to be the taxpayer’s return for the period, but has discretion to accept or reject an amended return filed after that time. Obvious administration and legal problems could result from allowing the filing of supplemental returns at the taxpayer’s option. M. Saltzman, I.R.S. Practice and Procedure, 4-14 (2d. ed. 1991).

Goldstone v. Commissioner, 65 T.C. 113, 116 (1975), states that cases which uphold the validity of amended returns fall within one of the following factual contexts: (1) the amended return was filed prior to the date prescribed for filing the original; (2) the taxpayer’s treatment of the item in the amended return was not inconsistent with the treatment in the original return; or (3) the taxpayer’s treatment of the item in the original return was improper and the taxpayer elected one of several allowable alternatives in the amended return.

In the present case, Taxpayer has failed to follow the requirements for filing an amended return. None of the above-mentioned three conditions applies to the present case. The amended returns were filed after the prescribed dates for the original returns. Secondly, Taxpayer's treatment of the contested item in the amended returns was inconsistent with its treatment in the original returns, substituting end-year for mid-year data and grouping the mortgages differently. Thirdly, Taxpayer's treatment of the item in its original returns was improper, but Taxpayer did not elect an allowable alternative in the amended return, and merely chose to submit a less objectionable modification of its improper original treatment.

Taxpayer's treatment on the original returns was incorrect because pools of mortgage servicing rights are not assets having erratic income streams due to popularity, as required by Rev. Rul. 60-358. The treatment was improper because it used an estimate of the income for the current taxable year, whereas Rev. Rul. 60-358 contemplates actual income for the taxable year. The treatment on the original returns was additionally improper because Rev. Rul 60-358 states that total estimated income should be based on conditions known to exist at the end of the period for which the return is made, yet the original return was based on mid-year data. Further, Rev. Rul. 60-358 contemplates application of an annually revised income forecast ratio to the same asset year after year. The original returns grouped the servicing rights by year of acquisition for year 1, grouped all pre-year servicing into one asset distinct from the year 2 servicing for year 2, and treated year 3 similarly to year 2 except that the largest pre-year 3 asset was also treated as a distinct asset.

The amended returns cured the last impropriety, but others remain. The amended returns treated the pools of mortgage servicing rights as the type of asset for which the income forecast method is available, despite the lack of an erratic income stream due to popularity. The amended returns still used an estimate of the income for the current taxable year. Moreover, Rev. Rul. 60-358 contemplates application of an annually revised income forecast ratio to the same asset year after year. For year 1, the amended returns grouped loans by year of origination but for years 2 and 3, the amended return grouped loans by year of acquisition. There also does not appear to be an adequate explanation of why the groupings on the amended returns were different from the groupings on the original returns. Per-year 1 asset pools' accounting is beyond the scope of this memorandum.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

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